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NOTES

ESTATE TAX VALUATION OF MUTUAL FUND SHARES. AN UNREALISTIC REGULATION

The Federal Estate Tax, "originally conceived as an emergency measure,"¹ is a permanently established feature of today's taxing system. Imposed upon the privilege of transmitting property at death, the estate tax is measured according to the value of the property transferred.² Specified exemptions and deductions are deducted from the value of the gross estate³ resulting in the taxable estate which is taxed at a progressive rate, graduated according to estate size.⁴ Since the tax is measured according to value, the valuation procedures used are of prime importance in computing the amount of tax due.

The cryptic provisions of the Internal Revenue Code offer little guidance in ascertaining the value of the gross estate, indicating merely

The value of the gross estate of the decedent shall be determined by including to the extent provided for in this part, the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated.⁵

The code also provides that "[t]he value of the gross estate shall include the value of all property to the extent of the interest therein of the decedent at the time of his death."⁶ Although Congress has enacted similar statutes since 1916,⁷ all of these provisions likewise have

1. C. LOWNDES & R. KRAMER, *FEDERAL ESTATE AND GIFT TAXES* § 2.1, at 5 (2d ed. 1962) [hereinafter cited as LOWNDES & KRAMER]. The Federal Estate Tax was originally instituted "to defray the cost of preparedness as represented in the additional appropriations for the Army, Navy, fortifications, Military Academy, and deficiencies caused by the military situation." S. REP. NO. 793, 64th Cong., 1st Sess. 1 (1916).

2. INT. REV. CODE OF 1954, §§ 2001, 2031, 2033.

3. *Id.* §§ 2051-56.

4. *Id.* § 2001.

5. *Id.* § 2031.

6. *Id.* § 2033.

7. "[Be it enacted] SEC. 202. That the value of the gross estate of the decedent shall be determined by including the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated:

(a) To the extent of the interest therein of the decedent at the time of this death

been couched in general terms, and Congress has delegated to the Internal Revenue commissioner the power to issue "needful rules and regulations" implementing statutory intent.⁸

In pursuance of this delegated duty, the commissioner has issued numerous regulations on valuation of property for estate tax purposes. A relatively recent treasury regulation on valuation has become the center of a growing controversy. This regulation prescribes a new criterion to be used in mutual fund⁹ share valuation:

The fair market value of a share in an open-end investment company (commonly known as a "mutual fund") is the public offering price of a share, adjusted for any reduction in price available to the public in acquiring the number of shares being valued.¹⁰

Since the public offering price of load fund shares includes an acquisition expense or sales load which adds nothing to the value of the shares,¹¹ this regulation has been strongly criticized as unrealistic and

which after his death is subject to the payment of the charges against his estate and the expenses of its administration and is subject to distribution as part of his estate." Int. Rev. Act of 1916, ch. 463, § 202, 39 Stat. 777.

8. The Internal Revenue commissioner's authorization to issue "needful rules and regulations for the enforcement of this title" is currently embodied in section 7805(a) of the Internal Revenue Code of 1954. He had been authorized to issue such regulations prior to institution of the Federal Estate Tax. Act of Dec. 1, 1873, ch. 8, § 321, 18 Stat. 52. The commissioner was specifically authorized to promulgate regulations for estate tax in 1916. Int. Rev. Act of 1916, ch. 463, § 212, 39 Stat. 780.

9. A mutual fund, or open-end investment company, sells shares in itself and with the proceeds invests in the securities of other companies. It is required by law to offer its shares only at a "current public offering price described in the prospectus" (public offering price), Investment Company Act of 1940, 15 U.S.C. § 80a-22(d) (1970), and to repurchase its shares from owners wishing to sell at their current net asset value (redemption price), *id.*, §§ 80a-2(a)(32), 80a-3(a), 80a-4(3), 80a-5(a)(1), 80a-22(a)(1). At the end of 1971, there were 10.9 million mutual fund shareowner accounts. INVESTMENT COMPANY INSTITUTE, 1972 MUTUAL FUND FACT BOOK 3. On formation, structure and operation of mutual funds, *see generally* SEC, PUBLIC POLICY IMPLICATIONS OF INVESTMENT COMPANY GROWTH, H.R. REP. NO. 2337, 89th Cong., 2d Sess. (1966) [hereinafter cited as H.R. REP.]; Lobell, *The Mutual Fund: a Structural Analysis*, 47 VA. L. REV. 181 (1961); *Conference on Mutual Funds*, 115 U. PA. L. REV. 659 (1967).

10. Treas. Reg. § 20.2031-8(b), T.D. 6680, 1963-2 CUM. BULL. 418-19.

11. The public offering price of a no-load fund is established by deducting its liabilities from the total market value of its assets and dividing the result by the number of shares outstanding. Public offering price thus approximates the current net asset value per share outstanding. However, shares of a load fund, distributed through underwriters, dealers and brokers, include in their public offering price a sales load which is frequently as high as 9.3 percent of the net asset value of shares purchased. The difference between public offering price and redemption price of load funds thus represents the sales load. The current controversy revolves around whether this acquisition charge, or sales load, should be included in the "value of the gross estate." Authorities on mutual funds have made the following observations:

unreasonable. Taxpayers' challenges to Treasury Regulation 20.2031-8(b) have resulted in conflicting decisions among the federal courts of appeal.¹² Recently, the Ninth Circuit in *Davis v. United States*¹³ and the Second Circuit in *Cartwright v. United States*¹⁴ have held this regulation invalid.

This note will discuss relevant valuation criteria prescribed in past regulations, consider arguments for and against the present mutual fund share regulation, and review decisions ruling upon its validity. This note will conclude with a recommendation that the well reasoned decision of *Cartwright* be affirmed.

Estate Tax—Regulatory History

Courts which have upheld Treasury Regulation 20.2031-8(b) repeatedly have cited *Commissioner v. South Texas Lumber Co.*¹⁵ That case stated that "Treasury Regulations . . . constitute contemporaneous constructions by those charged with administration of these statutes which should not be overruled except for weighty reasons."¹⁶ Treasury Regulation 20.2031-8(b), however, is not a contemporaneous construction of

"The sales charge goes solely to compensating the salesman, and for promotion. Not a cent of this pays for fund management's investment advice or otherwise benefits the fund itself in any way." N. DACEY, DACEY ON MUTUAL FUNDS 47 (1970) [hereinafter cited as DACEY]. It is not the value of mutual fund assets, but "[c]ompetition for dealer interest among . . . underwriters" which has "exerted an upward pressure on sales loads." H.R. REP., *supra* note 9, at 56. The result of this "upward pressure" is that mutual fund shareholders "usually pay considerably more to acquire their shares than other types of investors pay for both the acquisition and the sale of their shares." *Id.* at 77. An investor who "has already decided to buy a particular [load] fund's shares must . . . pay sales charges designed to cover selling efforts that he does not want, does not need, and does not get." *Id.* at 221. "No-load funds . . . furnish the same professionally managed, diversified portfolios as load funds do; yet no-load fund shares are available without the sales charges that investors pay when they buy load fund shares. . . . Managerial expertise and portfolio diversification are paid for by other charges. . . . The sales load . . . is purely a payment for selling effort." *Id.* at 214-15. The Securities and Exchange Commission recommended statutory prohibition of sale of mutual fund shares at a public offering price comprising a sales load of more than five percent of the sum actually invested by the issuer of the shares. *Hearings on S. 1659 Before the Senate Comm. on Banking and Currency*, 90th Cong., 1st Sess., 924 (1967).

12. See text accompanying notes 60-70 *infra*.

13. 460 F.2d 769 (9th Cir. 1972).

14. 457 F.2d 567 (2d Cir. 1972), *cert. granted*, 41 U.S.L.W. 3183 (U.S. Oct. 10, 1972).

15. 333 U.S. 496 (1948), *cited in* *Ruehlmann v. Commissioner*, 418 F.2d 1302, 1304 (6th Cir. 1969); *Howell v. United States*, 414 F.2d 45, 48 (7th Cir. 1969); *Wells v. Commissioner*, 50 T.C. 871, 875 (1968).

16. 333 U.S. at 501.

any provision of the Internal Revenue Code,¹⁷ nor does it follow closely upon the advent of mutual funds, which originally appeared in the United States in the 1920's.¹⁸

Perhaps, then, some guidance in the current controversy may be found by consulting the more nearly "contemporaneous constructions by those charged with administration of these statutes"¹⁹ Regulations issued in 1921 specified that the "value to be ascertained [in determining value of the gross estate] is the market, or sale, value of the property"²⁰ while those of 1924 used the formula of "fair market value."²¹ As noted by one commentator:

The Federal Estate Tax Statute does not define the word "Value" but uses the term . . . without limitation. In the absence of a statutory definition the Treasury Department has defined the terms as meaning "fair market value" and this definition, which accords with the evident intent of the statute, has been accepted without question and is clearly correct.²²

Reference to the regulations preceding those in which the phrase "fair market value" first appeared helps explain the meaning which that phrase was intended to convey. After indicating that the pertinent value was the market, or sale, value of the property, the 1921 Regulations elucidated:

The highest price obtainable for the property within a reasonable period of the decedent's death is the value to be included. A sale of the property, however, in order to be accepted as the criterion of value, must be made in such manner as to insure the best price obtainable under existing circumstances. This requires (a) that the sale be made as a matter of business, and not merely in order to establish value; (b) . . . with a view to realizing as high a price as possible; and (c) that reasonable care and skill be exercised to obtain such price.²³

Market value in this regulation was defined as the value in cash which the estate could obtain by sale of the property. This general valuation principle has been expressed in an income tax context as "what-you-could-have-got-for-it-in-money-if-you-had-sold-it."²⁴ The

17. "[S]ince the statutory definition of value had been in the Revenue Acts since 1916, it is obvious that this Regulation cannot in any sense be deemed a contemporaneous construction of the statute. . . ." *Davis v. United States*, 306 F. Supp. 949, 953 (C.D. Cal. 1969).

18. DACEY, *supra* note 11, at 23.

19. 333 U.S. at 501.

20. Treas. Reg. 37, Art. 14 (1921).

21. Treas. Reg. 68, Art. 13(1) (1924).

22. 2 CCH STANDARD FEDERAL TAX SERV., ¶ 2021.02 (1931).

23. Treas. Reg. 37, Art. 14 (1921).

24. *Andrews v. Commissioner*, 135 F.2d 314, 317 (2d Cir.), *cert. denied*, 320 U.S. 748 (1943). While this definition was promulgated in an income tax context, "[t]here is no distinction, for most purposes . . . in the meaning of fair market value

sale requirements enumerated in the 1921 version of the regulations were condensed the following year in a formula which has survived in substance down to the present regulations:

[Market value is] the price which a willing buyer will pay to a willing seller for the property in question under the circumstances existing at the date of the decedent's death or within such reasonable period thereafter as would afford proper opportunity for an examination and sale thereof.²⁵

The "willing-buyer-willing seller" formula thus emerged as a more generalized rule. That is, the estate was valued by theoretically placing the executor in the role of a good faith willing seller vis-à-vis a good faith willing buyer, thereby excluding a collusive sale for the purpose of establishing a low valuation of property.

This willing buyer-willing seller formula has been explained by Lowndes and Kramer as the proper valuation rule:

Valuation is based upon the gross amount which the willing buyer will presumably pay without any subtraction for the seller's selling costs or commissions, income taxes, or other taxes payable by the seller out of the proceeds of the property, such as sales and excise taxes.²⁶

Inherent in this explanation, is the understanding that the estate is the willing seller. Thus it appears that "[t]he touchstone of fair market value has always been the price which a willing seller could reasonably be expected to be able to obtain from a disposition of the property in question."²⁷

Valuation of Mutual Fund Shares

The general willing buyer-willing seller rule has been found to be inappropriate for valuation of a specific category of property interests. This class of property interests, comprised of certain life insurance and annuity contracts, has been recognized as requiring a special valuation rule because of their atypical character.²⁸ In contrast, mutual fund

as used in an estate tax case and one involving income tax." *Champion v. Commissioner*, 303 F.2d 887, 892-93 (5th Cir. 1962).

25. Treas. Reg. 63, Art. 13 (1922). For current phrasing see Treas. Reg. § 20.2031-1(b), T.D. 6826, 1965-2 CUM. BULL. 368.

26. LOWNDES & KRAMER, *supra* note 1, § 18.12, at 441.

27. *Wells v. Commissioner*, 50 T.C. 871, 878 (1968) (Tannenwald, J., dissenting). Judge Tannenwald concluded: "It is the total amount obtainable by the seller from the only available actual purchaser, not the price which a theoretical purchaser would pay another seller, which should control." *Id.* at 880.

28. Characteristics peculiar to such insurance policies had been deemed to justify their evaluation for gift and estate tax purposes at replacement value. *United States v. Ryerson*, 312 U.S. 260 (1941); *Guggenheim v. Rasquin*, 312 U.S. 254 (1941); *DuPont v. Commissioner*, 233 F.2d 210 (3d Cir.), *cert. denied*, 352 U.S. 878 (1956).

shares had been recognized by the commissioner to be in the same classification as securities which were valued under the willing buyer-willing seller rule.²⁹ However, by issuing Treasury Regulation 20.2013-8(b), the commissioner unexpectedly classified mutual fund shares with insurance and annuity contracts. While the mutual fund shares had "superficial similarities"³⁰ with such contracts, they were fundamentally disparate in nature.

"['I]nsurance' involves a guarantee that at least some fraction of the benefits will be payable in fixed amounts,"³¹ and "[a]n annuity may be defined as an insurance contract wherein the insurer, in consideration of a certain premium, promises to pay a definite amount of income to the annuitant."³² In comparison, mutual fund shares do not entail a contract for payment of a fixed sum. The owner of an insurance contract may be able to sell it for more than its cash surrender value, but the owner of mutual fund shares realistically cannot expect to obtain more than their redemption price upon sale.³³ Contractual assurance that a specified sum will be paid, possibility of sale at more than cash surrender value and considerations of varying insurability³⁴ help justify valuation of insurance and annuity contracts at replacement value. No such justification exists in the case of mutual fund shares.³⁵

The classification of insurance contracts and mutual fund shares in the same category carried in its wake a fundamental and radical change in mutual fund share valuation. Taxpayers had formerly valued such shares at redemption price—the sum which the estate could realize by their sale.³⁶ Treasury Regulation 20.2031-8(b), by requiring inclusion of the sales load in valuation of mutual fund shares, in effect ordered the estate to value the shares at their "retail" cost. The

29. *Report of the Committee on Estate & Gift Taxes*, 19 BULL. A.B.A. SECTION OF TAXATION, July 1966, at 73.

30. Comment, *Taxation—Valuation of Shares in Open-End Investment Companies for Federal Estate Tax Purposes Held to Be Replacement Cost*, 44 N.Y.U.L. REV. 416, 419 (1969).

31. *SEC v. Variable Annuity Life Ins. Co.*, 359 U.S. 65, 71 (1959).

32. *Meisenholder, Taxation of Annuity Contracts under Estate and Inheritance Taxes*, 39 MICH. L. REV. 856, 863 n.17 (1941).

33. *Cartwright v. United States*, 457 F.2d 567, 569 (2d Cir. 1972).

34. "[W]hen the insured is uninsurable, the policy is worth more than the cost of a like policy" 54 HARV. L. REV. 894, 895 (1941).

35. One essential difference between insurance contracts and mutual fund shares is that mutual fund shares do not furnish the "type of promise which is basic to an insurance undertaking." Gordon, *Investment-Insurance Arrangements*, in CONFERENCE ON MUTUAL FUNDS 34 (1966). "[T]he mutual fund cannot promise to . . . pay any specific amount of income." INVESTMENT COMPANY INSTITUTE, 1972 MUTUAL FUND FACT BOOK 5.

36. *Report of the Committee on Estate & Gift Taxes*, 19 BULL. A.B.A. SECTION OF TAXATION, July 1966, at 73. See also text accompanying note 29 *supra*.

improper classification of mutual fund shares with insurance contracts resulted in treating the estate as a willing buyer instead of the traditionally accepted willing seller.

20.2031-8(b)—The Beginning

What began as an erroneous categorizing of mutual fund shares with insurance contracts was to have still further consequences. Regulation 20.2031-8(b) prescribing valuation of mutual fund shares represented the vanguard effort of the commissioner to effect a fundamental change in the method of property valuation for estate tax purposes. One day subsequent to the issuance of 20.2031-8(b), an amendment prescribing a retail basis of valuation for *all* "property in general" made its appearance as a proposal "in tentative form" in the Federal Register.³⁷ Previously, the Estate Tax Regulations had offered the traditional explication of fair market value:

The fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts. The fair market value of a particular item of property includible in the decedent's gross estate is not to be determined by a forced sale price.³⁸

In 1965, however, 20.2031-1(b) was amended to include the following sentences:

Nor is the fair market value of an item of property to be determined by the sale price of the item in a market other than that in which such item is most commonly sold to the public Thus, in the case of an item of property includible in the decedent's gross estate, which is generally obtained by the public in the retail market, the fair market value of such an item of property is the price at which the item or a comparable item would be sold at retail. For example, the fair market value of an automobile (an article generally obtained by the public in the retail market) includible in the decedent's gross estate is the price for which an automobile of the same or approximately the same description, make, model, age, condition, etc., could be purchased by a member of the general public and not the price for which the particular automobile of the decedent would be purchased by a dealer in used automobiles.³⁹

Thus Treasury Regulation 20.2031-8(b), owing its existence to an unwarranted classification of mutual fund shares with insurance and annuity contracts, served as a precedent for the more ambitious amendment of 1965. This amendment to 20.2031-1(b) in turn was used by the commissioner as a bootstrap argument when estate taxpayers later

37. Proposed Treas. Reg. § 20.2031-1(b), 28 Fed. Reg. 10882 (1963).

38. Treas. Reg. § 20.2031-1(b), T.D. 6296, 1958-2 CUM. BULL. 479.

39. Treas. Reg. § 20.2031-1(b), T.D. 6826, 1965-2 CUM. BULL. 368.

contested valuation of their mutual fund shares at a figure greater than that which could be realized by their sale:

The method prescribed by Section 20.2031-8(b) for the valuation of mutual fund shares accords with the principles of valuation for estate tax purposes set forth in the more general regulation (Section 20.2031-1(b)), which provides that the fair market value of an item generally obtainable at retail is its retail price and not the price obtainable by selling it back to a dealer.⁴⁰

To date, as noted in a taxpayer's challenge of the mutual funds regulation, the departure from traditional estate tax valuation of property embodied in Treasury Regulation 20.2031-1(b)'s retail market theory of valuation is not being enforced by the commissioner.⁴¹ It is only the narrower retail market theory of 20.2031-8(b) which the commissioner is endeavoring to enforce and which has recently created conflict between the circuits.

Realistic Valuation of Securities

Despite the anomalous grouping of mutual fund shares with insurance and annuity contracts in the current regulations, "[t]he first lesson which we must learn in connection with mutual funds is that mutual fund shares constitute securities."⁴² Thus, the revolutionary character of the new regulation concerning valuation of mutual fund shares can be highlighted by consideration of other regulations pertaining to estate tax valuation of securities. An early regulation for security valuation provided:

The value of stocks and bonds listed upon a stock exchange should be determined by taking the mean between the highest and lowest quoted selling price upon the date of death. . . .

. . . .

Where securities are actively quoted on a bid and asked basis and actual sales are not available, the bid price as of the date of death will be accepted as the value.⁴³

In the over-the-counter securities market, the bid price, or what the dealer "maintaining a market"⁴⁴ in a particular security is offering to pay, approximates what the owner may expect to get for his stock.

40. Brief for Appellant at 13, *Davis v. United States*, 460 F.2d 769 (9th Cir. 1972).

41. Brief for Appellee at 23, *Cartwright v. United States*, 457 F.2d 567 (2d Cir. 1972).

42. Hopper, *Antifraud and Disclosure Requirements in Selling Investment Company Securities*, in CONFERENCE ON MUTUAL FUNDS 15 (1966).

43. Treas. Reg. 63, Art. 14(2) (1922).

44. A dealer "maintains a market" in a security when he "is known to be willing at all times to buy or sell that security . . . at the prices he quotes." L. LOLL, JR. & J. BUCKLEY, *THE OVER-THE-COUNTER SECURITIES MARKETS* 146 (2d ed. 1967).

In the exchange or auction market, however, a sale is more likely to occur between the highest bid and the lowest asked price. Perhaps with the exchange market in mind, the regulation was amended in 1934 to read:

In the case securities are quoted on a bona fide bid and asked basis, and actual sales are not available, the mean between the bid and asked prices as of the date of death, or the nearest date thereto if within a reasonable time thereof, will be accepted as the value.⁴⁵

These principles of valuation of securities were based on market realities. However, the commissioner in amending the regulations has not always examined such realities when defining fair market value. For example, when an estate included large blocks of corporate stock, taxpayers contended that it was not realistic to arrive at the fair market value of such a block by multiplying the value of one share times the number of shares held by the estate. This contention was premised on the fact that placing a large block of stock on the market would depress the per share price. This blockage theory, although in accord with the meaning of fair market value as used in the regulations, was vigorously contested by the commissioner, and in 1934 the regulations were amended to specifically prohibit the use of the blockage principle:

The fair market value of a particular kind of property includible in the gross estate is not to be determined by a forced sale price or by an estimate of what a whole block or aggregate would fetch if placed upon the market at one and the same time.⁴⁶

The size of holdings of any security to be included in the gross estate is not a relevant factor and will not be considered in such determination.⁴⁷

Despite the commissioner's "broadside leveled at any 'Blockage Rule'," ⁴⁸ taxpayers still contended that refusal to apply such a rule resulted in a "formalistic method which is at variance with

45. Treas. Reg. 80, Art. 13(3) (1934). In *McNary v. Commissioner*, 47 T.C. 467 (1967), a taxpayer petitioned the Tax Court to find that "the only proper criterion for determining the fair market value of the securities included in the assets of this estate, the values of which were, on the valuation date, quoted on the over-the-counter market, is the quoted bid price." *McNary v. Commissioner*, 47 T.C. 467, 469 (1967). The court in holding for respondent emphasized that petitioner had taken its position "[w]ithout the citation of any authority." *Id.* Authority may perhaps be found in the original reading of the applicable regulation. The 1934 amendment allows a more exact valuation of "fair market value" or what the owner can obtain by sale of stock quoted on an exchange, but it may not lead to a more reasonable determination of "fair market value" of stock which is sold over the counter.

46. Treas. Reg. 80, Art. 13(1) (1934).

47. *Id.*, Art. 13(3).

48. Peters, *The Fair Market Value of Blocks of Stock*, 17 TAXES 17, 18 (1939).

reality”⁴⁹—the pertinent reality being “the point at which supposititious willing buyers might agree with this seller.”⁵⁰

In a case where decedent owned 35,966 shares of a particular stock, the commissioner valued this block at \$44 per share, based on sales of a few hundred shares at prices between \$45 and \$43 on the date of death. In view of the general downward trend, it was certain that if so large a block had been placed on the market on that date, “the price would . . . have . . . been instantly depressed.”⁵¹ Concluding that “the Commissioner’s method . . . does not, as to this block of shares, result in a figure which is consistent with reality,”⁵² the Board of Tax Appeals found that the value of the 35,966 share block was not more than \$35 per share. The Fourth Circuit affirmed holding that “the Board was right in basing its conclusions upon the realities as it found them It could not ignore the pregnant fact, having found it to exist, that a large block of stock cannot be marketed and turned into money as readily as a few shares.”⁵³ The Fourth Circuit in a subsequent decision in which it applied the blockage rule stated that its decision was reached “notwithstanding the restrictive provisions of the regulations.”⁵⁴ Another court, in applying the blockage rule, reconciled its decision with the regulations stating: “[t]he regulations . . . provide that ‘all relevant facts and elements of value as of the time of the decedent’s death should be considered in every case.’”⁵⁵ The practical outcome of these cases was similar, because both courts refused to be bound by a regulation not “consistent with reality.”⁵⁶

49. *Safe Deposit & Trust Co. v. Commissioner*, 35 B.T.A. 259, 262 (1937).

50. *Id.* at 263.

51. *Id.* at 262.

52. *Id.* at 262-63.

53. *Helvering v. Safe Deposit & Trust Co.*, 95 F.2d 806, 812 (4th Cir. 1938).

54. *Helvering v. Kimberly*, 97 F.2d 433, 434 (4th Cir. 1938). This case concerned valuation for gift tax purposes, but the Gift Tax Regulations had been similarly amended to include an anti-blockage provision. *Treas. Reg.* 79, Art. 19(3) (1932).

55. *Knobloch v. Smith*, 25 F. Supp. 156, 157 (D. Conn. 1938). Decedent owned 14,778 shares of a stock of which 200 shares were sold at \$19 per share on the valuation date. “The Government relie[d] solely on the proposition that certain provisions of the regulations, which require disregard of blockage, are controlling.” *Id.* at 157. Noting that so large a block of stock could have been sold on valuation date only “to an underwriter . . . who would want a concession of from three to five points below the market,” the court valued the stock at \$15 per share. *Id.* at 156.

56. *Accord*, *Commissioner v. Shattuck*, 97 F.2d 790 (7th Cir. 1938); *Jenkins v. Smith*, 21 F. Supp. 251, 253 (D. Conn. 1937), wherein the court stated: “Although there was no actual necessity for a sale of the total block of stock on the date of the decedent’s death, the determination of the fair market value as of that date requires the estimation of the price that could have been obtained for all the shares on that day, for the reason that fair market value as of a given date means the price that could

After encountering this judicial reluctance, the blockage proscription was deleted from the regulations.⁵⁷ The demise of this prohibition made possible a realistic valuation of large blocks of stock. Conversely, the new mutual fund share regulation precludes valuation on a realistic basis. This lack of economic reality has been a key factor in the recent judicial refusals to uphold Treasury Regulation 20.2031-8(b).

Regulation 20.2031-8(b) and the Courts

Courts refusing to uphold Treasury Regulation 20.2031-8(b) have treated it as "unrealistic" and "artificial."⁵⁸ When this regulation is taken in combination with the 1965 amendment to Treasury Regulation 20.2031-1(b), it appears as not only an unrealistic regulation but one which ignores the legislative intent of statutes pertaining to the estate tax, as revealed in earlier regulatory constructions and court interpretations.⁵⁹ However, the courts initially failed to question its lack of economic reality. The first challenge to Treasury Regulation 20.2031-8(b) occurred in *Wells v. Commissioner*.⁶⁰ Noting that treasury regulations are not to be held invalid merely because a taxpayer suggests reasonable or preferable alternatives, but "are to be sustained unless they are found to be unreasonable and plainly inconsis-

actually have been realized on that date." *But cf.* *Richardson v. Helvering*, 80 F.2d 548 (D.C. Cir. 1935); *Roth v. Wardell*, 77 F.2d 124 (9th Cir. 1935).

57. Treas. Reg. 80, Art. 10, T.D. 4902, 1939-1 CUM. BULL. 325. Eventually, "the pressure of judicial recognition of the blockage concept culminated in its inclusion in the 1958 Regulations." Riecker, *Blockage in Federal Estate and Gift Tax Valuation*, 42 MICH. ST. B.J., Aug. 1963, at 26. Current Treasury Regulation 20.2031-2(e) provides for consideration of the size of the block of stock to be valued "[i]n certain exceptional cases." The taxpayer still has to present convincing evidence that placing the block to be valued on the market within a reasonable period from valuation date would have depressed the price per share.

58. *E.g.*, *Cartwright v. United States*, 323 F. Supp. 769, 772 (W.D.N.Y. 1971): "To include [the sales commission] in the value of the shares to the estate creates an artificial value . . ."; *Davis v. United States*, 306 F. Supp. 949, 955 (C.D. Cal. 1969): "To include the fictitious sales commission in the value of the shares to the estate is to create an artificial value that cannot possibly be obtained by the estate in any readily accessible, realistic market"; *Hicks v. United States*, 335 F. Supp. 474, 482 (D. Colo. 1971): "[T]his regulation . . . taxes a value which does not exist." *See also* J. RABKIN & M. JOHNSON, 4 FEDERAL INCOME, GIFT & ESTATE TAXATION § 52.11, at 5291 (1972): "The Sixth Circuit . . . has upheld this unrealistic regulation."

59. "[T]he 1963 and 1965 amendments to the Regulations . . . [appear] to be a dangerous and unwarranted departure from the traditional fair market value concept developed by the courts in which the determination of the price obtainable between a willing buyer and a willing seller is oriented to the market or markets available to the holder of the property being valued." *Report of the Committee on Estate and Gift Taxes*, 19 BULL. A.B.A. SECTION OF TAXATION, July 1966, at 74.

60. 50 T.C. 871 (1968).

tent with the revenue statutes,"⁶¹ the Tax Court with six judges dissenting concluded that the regulation was reasonable. Soon after the *Wells* decision, the analogous gift tax regulation⁶² came before the District Court for the Northern District of Indiana in *Howell v. United States*.⁶³ The *Howell* court citing *Wells* declared that it was "not convinced . . . that the Regulation . . . is unreasonable or out of harmony with the statute."⁶⁴ The Sixth Circuit also affirmed the Tax Court's *Wells* decision noting that although prior to 1963 the regulations had not prescribed valuation of mutual fund shares at public offering price, "[t]he Commissioner has chosen [another] criterion and, if it is a reasonable one, we are not at liberty to second guess him."⁶⁵

The trend to hold the regulation invalid began with *Davis v. United States*⁶⁶ in which the District Court for the Central District of California concluded that a regulation so unrealistic could not be reasonable. This opinion has been cited approvingly by the district courts for both the Western District of New York⁶⁷ and the District of Colorado.⁶⁸ The Second Circuit in *Cartwright v. United States*⁶⁹ also has recently held that Treasury Regulation 20.2031-8(b) is unrealistic and establishes an improper criterion for valuation of mutual fund shares. The Ninth Circuit has affirmed the *Davis* decision,⁷⁰ thus becoming the second court of appeals to hold Treasury Regulation 20.2031-8(b) invalid. The United States Supreme Court has granted certiorari in the *Cartwright* decision⁷¹ and will resolve the present conflict. A brief review of the arguments for and against Treasury Regulation 20.2031-8(b) may suggest what the outcome will be in the Supreme Court.

Arguments Presented in the Cases

The commissioner in support of Treasury Regulation 20.2031-8(b) points out that it is consistent with the 1965 revision of 20.2031-

61. *Id.* at 875.

62. An amendment providing for valuation of mutual fund shares at public offering price for gift tax purposes was added to the gift tax regulations at the same time that the mutual fund amendment was added to the estate tax regulations. T.D. 6680, 1963-2 CUM. BULL. 417.

63. 290 F. Supp. 690 (N.D. Ind. 1968), *aff'd*, 414 F.2d 45 (7th Cir. 1969).

64. *Id.* at 694.

65. *Ruehlmann v. Commissioner*, 418 F.2d 1302, 1304 (1969), *cert. denied*, 398 U.S. 950, *rehearing denied*, 400 U.S. 856 (1970).

66. 306 F. Supp. 949 (C.D. Cal. 1969).

67. *Cartwright v. United States*, 323 F. Supp. 769, 772 (W.D.N.Y. 1971).

68. *Hicks v. United States*, 335 F. Supp. 474, 480-81 (D. Colo. 1971).

69. *Cartwright v. United States*, 457 F.2d 567, 571-72 (2d Cir. 1972).

70. *Davis v. United States*, 460 F.2d 769 (9th Cir. 1972).

71. 41 U.S.L.W. 3183 (U.S. Oct. 10, 1972).

1(b).⁷² Furthermore, he contends that the only willing buyer-willing seller transaction which occurs with regard to mutual funds is the one in which individuals purchase shares at the public offering price since the fund is required by statute to redeem shares at a set redemption price.⁷³ The district court in *Cartwright* noted that this "theory disregards the facts of acquisition"⁷⁴ where shares are acquired by inheritance or at redemption price through reinvestment of dividends.⁷⁵ The court also criticized the argument's disregard of the fact that "both the buyer and seller . . . willingly enter into the transaction,"⁷⁶ which includes agreement on the part of the fund to redeem the shares at net asset value when the owner decides to sell them. The Ninth Circuit similarly declared that open-end investment companies are willing buyers when they redeem shares since "the redemption market is the market upon which both parties agree when the shares are purchased. The mutual fund chooses to operate in such form under the law and the public buys shares in the fund fully apprised of its redemption opportunities through company prospectuses."⁷⁷ The Investment Company Institute⁷⁸ states that the decision to engage in business as an open-end investment company entails a voluntary decision to accept the legal obligation to redeem shares and that a mutual fund is thus a "willing buyer."⁷⁹

The commissioner also argued that mutual fund shares should be valued similarly to insurance policies on the life of a person other than the decedent and annuity contracts, which had previously been in a category by themselves for estate tax valuation.⁸⁰ The majority in *Wells v. Commissioner* was persuaded that the 1963 amendment to the regulations placing mutual funds in the same category with such insurance and annuity contracts was "recognition that investment company shares are a different breed of cats from ordinary stocks and bonds; and

72. *Cartwright v. United States*, 457 F.2d 567, 571 (2d Cir. 1972). See text accompanying notes 37-40 *supra*.

73. *Wells v. Commissioner*, 50 T.C. 871, 876 (1968).

74. 323 F. Supp. at 772.

75. Shareholders of some load funds are able to purchase additional shares at net asset value through reinvestment of dividends. H.R. REP., *supra* note 9, at 215.

76. 323 F. Supp. at 772.

77. *Davis v. United States*, 460 F.2d 769, 772 (9th Cir. 1972).

78. The Investment Company Institute is a trade association of the mutual fund industry. Its members hold about ninety-three percent of all mutual fund assets. H.R. REP., *supra* note 9, at 4 n.15.

79. Brief for Investment Company Institute as Amicus Curiae at 18, *Davis v. United States*, 460 F.2d 769 (9th Cir. 1972).

80. "The Treasury has . . . grouped mutual funds with those few types of assets which are valued at replacement cost." Marks, *Little-Publicized Valuation Regs. Mean Higher Estate and Gift Taxes*, 22 J. TAXATION 286 (1965). At the time this article was published, Treasury Regulation section 20.2031-1(b) had not been revised in an endeavor to add "property in general" to those "few types of assets" so valued. See text accompanying notes 28-35 *supra*.

when it comes to valuing them, a different criterion can reasonably be applied, more nearly like that applied to life insurance and annuity contracts than stocks and bonds."⁸¹ Unconvinced by this reasoning, the Colorado district court observed: "The Commissioner cannot cross-breed life insurance and investment trust shares by the simple expedient of discussing them in separate paragraphs of a single regulation."⁸² In *Cartwright* the Second Circuit fully concurred in the district court's refusal to accept the insurance-mutual fund share analogy.⁸³ In the words of the district court, "mutual funds and insurance policies are so different that the bundle of rights in each cannot be compared."⁸⁴ A Supreme Court case concerning valuation of an insurance policy has emphasized the contractual obligation of the insurer to pay a sum certain at a future date.⁸⁵ As noted in the *Wells* dissent, "there was no evidence that the [insurance] policy could not have been sold, albeit in a limited market, at its replacement value or at least at a price in excess of its cash surrender value."⁸⁶ In contrast "[t]he ordinary and only practical method of disposition [of mutual fund shares] is redemption."⁸⁷

The commissioner further argued that since inclusion of the excise tax in valuation of jewelry for estate and gift tax purposes has received court approval,⁸⁸ inclusion of the sales load in valuation of mutual fund shares similarly should be sanctioned.⁸⁹ The cases involving excise tax, however, emphasized taxpayer's failure to produce evidence supporting valuation at a lower price than that which had been paid.⁹⁰ One court concluded that the price paid by the taxpayer and "market value realizable on sale of the diamonds to an individual for his personal use might well have been substantially the same."⁹¹ Rev-

81. 50 T.C. 871, 876 (1968).

82. *Hicks v. United States*, 335 F. Supp. 474, 482 (D. Colo. 1971).

83. 457 F.2d 567, 570 (2d Cir. 1972).

84. 323 F. Supp. 769, 773 (W.D.N.Y. 1971).

85. *Guggenheim v. Rasquin*, 312 U.S. 254, 257 (1941): "[T]he owner of a fully paid life insurance policy . . . has the right . . . to receive the face amount of the policy upon the insured's death." See text accompanying notes 30-34 *supra*.

86. 50 T.C. at 879 (Tannenwald, J., dissenting).

87. 323 F. Supp. at 771.

88. *Publicker v. Commissioner*, 206 F.2d 250 (3d Cir. 1953), *cert. denied*, 346 U.S. 924 (1954); *Duke v. Commissioner*, 200 F.2d 82 (2d Cir. 1952), *cert. denied*, 345 U.S. 906 (1953); *Gould v. Commissioner*, 14 T.C. 414 (1950).

89. *Howell v. United States*, 414 F.2d 45, 49 (7th Cir. 1969).

90. "The sole evidence consisted of the cost to the taxpayer of obtaining the jewelry. . . ." *Duke v. Commissioner*, 200 F.2d 82, 84 (2d Cir. 1952). "The court [in *Publicker v. Commissioner*] stated that in view of the irreconcilable conflict of testimony of the expert witnesses, the cost of the jewelry, including . . . excise tax, was considered as the best evidence of value." Rev. Rul. 55-71, 1955-1 CUM. BULL. 110, 111.

91. *Publicker v. Commissioner*, 206 F.2d 250, 254 (3d Cir. 1953).

enue Ruling 55-71 further reveals the difficulty in drawing support for inclusion of the sales load by analogy to inclusion of the excise tax in valuation for estate tax purposes:

The existence of the Federal excise tax on jewelry, furs, and other related articles of personal property sold by dealers, is an item which will tend to increase the amount at which *an individual or an estate would be willing to sell such property*. . . .

In view of the foregoing, it is held that the Federal excise tax on . . . articles of personal property is a relevant factor which should be considered in determining the fair market value of such property for Federal estate and gift tax purposes.⁹²

Since the only practical manner of disposing of mutual fund shares is to resell them to the issuing company at redemption price, Judge Tannenwald, in his cogent and persuasive dissent in *Wells*, compared the situation of a person wishing to sell his mutual fund shares to that of one wishing to sell stock subject to a binding restriction, requiring that the "shares may not be sold without offering them to a third person at a certain price" in which case "that price becomes the ceiling for determining the fair market value of the shares for estate tax purposes."⁹³ Similarly, the district court in *Davis* concluded that "[a]lthough there is no binding contract in this case, the rationale of Treas. Reg. 20.2031-2(h) (1958) should apply to open-end investment shares because the redemption price offered by the company truly represents the only realistic value that the estate can obtain for the shares of the open-end investment company."⁹⁴ On appeal to the Ninth Circuit, the commissioner contended that the trial court had "erred in its analogy of mutual fund shares to a stock or bond that is subject to a binding contract to purchase" because such restrictive agreements "may operate to affect the fair market value of property for estate tax purposes [only if] the executor is obligated to sell for the price fixed by the agreement."⁹⁵ However, courts have repeatedly held that a restrictive agreement requiring the owner of stock to offer it to certain parties at a specified price before selling it to anyone else has a depressing effect upon the fair market value of the stock. Even if the right to purchase is not exercised by those who have the right of first refusal, the owner cannot expect to sell the stock for the price he could obtain were it not encumbered by a restriction. Thus fair market value in this instance as

92. Rev. Rul. 55-71, 1955-1 CUM. BULL. 110, 111 (emphasis added).

93. 50 T.C. at 878 (Tannenwald, J., dissenting).

94. 306 F. Supp. at 955. When securities are subject to an option or contract to purchase under which the decedent was not free to dispose of them "at any price he chooses during his lifetime" and which "represents a bona fide business arrangement," the option or contract price is considered in determining fair market value. Treas. Reg. § 20.2031-2(h), T.D. 6296, 1958-2 CUM. BULL. 481.

95. Brief for Appellant at 15-16, *Davis v. United States*, 460 F.2d 769 (9th Cir. 1972).

in others is determined by what the owner can realize in money for his property.⁹⁶

Conclusion

The Securities and Exchange Commission recently stated: "A person who invests in a load fund does not obtain an interest in the fund equal in value to the amount that he pays for his shares, since the sales load is first deducted from the purchase price."⁹⁷ Thus Treasury Regulation 20.2031-8(b) is inconsistent not only with the term value as used in Section 2031 of the Internal Revenue Code but also with the provision in Section 2033 that the gross estate is to include the value of all property "to the extent of the interest therein of the decedent at the time of his death."⁹⁸ These inconsistencies were recognized in *Davis*:

The sales load is a charge for service which is paid by the buyer at purchase and never recovered. It adds nothing to the value of the shares To apply the estate tax rate to the sales charge paid is to impose a tax on a nonexistent "interest of the decedent." The regulation which permits it . . . is inconsistent with . . . 26 U.S.C. § 2033.⁹⁹

The principal justifications of the Federal Estate Tax are generally considered to be production of revenue and prevention of excessive concentrations of wealth.¹⁰⁰ If these considerations now justify a change in the manner in which property is valued for estate tax purposes, the change should not culminate in a procedure which is patently unrealistic. If the commissioner wishes to effect changes, he must do so within the bounds of the congressional mandate from which he derives his authority and by regulations not inconsistent with the statutes they are designed to implement. Hopefully, the Supreme Court will resolve the current conflict between the statutes and regulations by affirming the decision in *Cartwright v. United States*.

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96. *E.g.*, *Worcester County Trust Co. v. Commissioner*, 134 F.2d 578, 582 (1st Cir. 1943) wherein the court stated: "To be sure the restriction does not affect the value of the stock so long as the owner does not wish to sell, but it is not this value which, under the regulations, is to be used as the basis for computing the tax. The value to be used for this purpose is the 'fair market value'" *Accord*, *Mathews v. United States*, 226 F. Supp. 1003 (E.D.N.Y. 1964). *But see* *Koch v. Commissioner*, 28 B.T.A. 363 (1933); *City Bank Farmers Trust Co. v. Commissioner*, 23 B.T.A. 663 (1931).

97. H.R. REP., *supra* note 9, at 52.

98. INT. REV. CODE OF 1954, § 2033.

99. *Davis v. United States*, 460 F.2d 769, 772 (9th Cir. 1972).

100. R. PAUL, *TAXATION FOR PROSPERITY* 214-15 (1947).

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